The Importance of Concentration Risk in Terms of Liquidity Risk Management

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Abstract

Liquidity generally refers to the ability of an asset to be converted into cash. However, for financial institutions, the mere ability to convert an asset into cash may not be a sufficient indicator. The acceleration in fund movements, especially with digitalization, has made the concentration risk important for liquidity. Concentration often appears in the context of credit risk and inequality. Bank bankruptcies witnessed in the USA and Switzerland at the beginning of 2023 also drew extra attention to the concentration in terms of liquidity risk.

Idea behind banks holding liquid assets against their liabilities is to ensure that they survive an adverse period, either bank specific or marketwise, without defaulting on their customers' withdrawals until central bank or other related authorities step in to take necessary actions. That's why almost all bank supervisors around the world require banks to have certain amounts of liquid assets and/or meet certain liquidity ratios. These requirements assume that liquid assets, which mostly include government securities or placements with central banks, complying with the conditions depicted in regulations can be successfully converted into cash to meet the customers' demand in stress periods. Then, the more is the better for banks in terms of liquidity adequacy, or is it so?

There is an extensive literature on banking's liquidity transformation and creation capacity. Also, there have been studies on liquidity risk management in banks recently. However, in order to assess liquidity, more emphasis is needed on the nature of liquid assets in banks' balance sheets and their share in the balance sheet. For this reason, it is useful to look closely at the course of liquid assets in banks' balance sheets and the nature of these liquid assets. The concentration risk which is of great importance for almost every type of risk, is also critical for liquidity risk and liquid assets. Therefore, it is thought that a concentration-oriented view, independent of the nature of liquid assets, is essential for assessing liquidity risk. Overdependence even on assets that are assumed to be risk-free or very liquid can cause serious vulnerabilities. Additionally, it would be beneficial to monitor level of these liquid assets system wide. Relying mostly on holding liquid assets representing a claim from only one counterparty for liquidity management creates concentration risk. Also, prudential authorities should be aware of concentration risk dimension of liquidity management at the individual bank level especially for contingency planning.

In this study, firstly, the relevant literature on the formation, source and management of liquidity risk in banking was examined. The capacity of banking to transform and create liquidity was mentioned. Particular attention was paid to the concentration discussions triggered by the bank failures that occurred in March 2023. Subsequently, the liquidity risk management principles developed by the Basel Committee on Banking Supervision over the years were evaluated. Then,

the possible effects of the concentration issue on liquidity risk are shown by the historical data of the Silocon Volley Bank, US and Turkish Banking Sectors. As a result, it is emphasized why concentration risk is so important in terms of liquidity.

The concentration indicates a risk, regardless of the intrinsic nature of assets. This refers a weight, which means excessive dependence on something. No matter how good and solid the quality of an asset is, excessive dependence on that eventually involves serious vulnerability. In fact, this is the reality that concentration risk fully reflects. This situation may be more dramatic in terms of liquidity risk. Liquidity transformation ability and providing liquidity are one of the most fundamental qualities and advantages of banks. These features are directly linked to the liquid assets on banks' balance sheets. Therefore, even sole the distribution of liquid assets in banks' assets is very important, regardless of how qualified they are. For instance, it is noteworthy that most of the liquid assets on bank balance sheets are in the form of investments in public entities. The banks need to manage the concentration issue prudently in every aspect in terms of liquidity risk management.

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